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SIPDIS

SENSITIVE

DEPT FOR AF/E, AF/EPS, EEB/IFD/OMA,
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TAGS: ECON EFIN EAGR ENRG KE
SUBJECT: KENYA CRISIS AFTERMATH: INFLATION SOARS, CONSUMERS AND
PRODUCERS SUFFER

REF: A. NAIROBI 762, B. NAIROBI 414

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¶1. (U) Summary: Driven mainly by food prices, seasonally adjusted overall annual inflation in Kenya rose to a record 12% in March, and underlying inflation continued to rise well above the target ceiling rate of 5%. Food prices rose 4.3% from February to March alone, as the aftermath of the crisis boosted the costs of fuel, farm inputs and transportation. Meanwhile, the displacement of farmers from the northern Rift Valley has led to forecasts of lower food production, boosting prices further. Low-income consumers are most impacted, but big increases in transportation and fuel prices hit all consumers and producers. Western areas of Kenya that experienced the worst violence face greater shortages and higher inflation. Local analysts warn that rising global oil and food prices are likely to keep inflation high throughout 2008. On the plus side, interest rates have not yet risen significantly and wage increases continue to lag well behind prices. Senior Government of Kenya officials have finally reduced their 2008 growth forecasts to 4.5%-6%. However, investors continue to seek Safaricom shares and buy long-term government bonds. High inflation is helping to fuel protests against the costs of an expanded coalition cabinet. End summary.

March Inflation Hits Record Levels

¶2. (U) Overall inflation rose 21.8% year-on-year (YOY) in March 2008, the highest rate since 1994, while seasonally adjusted (average annual) inflation rose to a record 12%. The underlying inflation rate, which excludes volatile food, energy and transportation prices, rose 7% YOY and a seasonally adjusted 5.5%, continuing to climb above the Central Bank of Kenya's (CBK) 5% target ceiling for money supply management. The 28.8% YOY increase and the 4.3% increase in food prices from February to March (MOM) were stunning demonstrations of the impact of the post-election violence and global markets on Kenya. Transport and communications and fuel and power prices rose 19.1% and 15.6% YOY in March respectively, but were only slightly changed from February levels -- see tables 1 and 2 below. The CBK's normally understated weekly bulletin took a more ominous tone on April 4: "Increasing food prices and high and rising prices of fuel and power continue to be the major threat to price stability and the cost of living."

Table 1: March 2008 Overall Month on Month (MOM) and YOY Inflation, not seasonally adjusted:

Item Group	MOM change	YOY Change
Food & Non-alcoholic drinks	4.3%	28.8%
Transport & Communication	-0.1%	19.1%
Fuel & Power	0.7%	15.6%
Alcohol & Tobacco	0.7%	14.2%
Medical Goods and Services	0.3%	8.0%
Household Goods & Services	1.1%	7.6%
Recreation & Education	0.1%	6.7%
Housing Costs	0.7%	6.2%
Personal Goods	0.8%	5.7%
Clothing & Footwear	0.9%	4.8%
Average all Groups	3.1	21.8%

1st Quarter Inflation Also Very High

¶3. (U) March inflation reflects a rapidly rising trend through the whole first quarter for all item groups, but food, fuel and power, transport and communication continue to lead the way, followed by alcohol and tobacco and housing. The consumer price index (CPI) has risen 14.5% since the end of December, the biggest quarterly jump since the severe drought of 2006.

Table 2 Q1 2008 overall inflation YOY % Changes:

Item Group	Jan	Feb	Mar	Q1 average
Food and Non-Alcoholic Drink	24.6%	24.9%	28.2%	25.9%
Fuel & Power	10.6%	14.1%	15.6%	13.4%
Transport & Communication	17.8%	18.5%	19.1%	18.5%
Housing	5.2%	5.9%	6.2%	5.8%
Medical goods & Services	3.6%	7.7%	8.0%	6.4%
Alcohol & Tobacco	12.8%	14.1%	14.2%	13.7%

Source: Kenya National Bureau of Statistics

¶4. (U) Inflation across income groups and geographic areas also rose sharply. The Nairobi lower income group continues to face the highest inflation rate, reaching 23.2% YOY in March. However, the other Kenyan towns in the survey are catching up: their prices rose 22% YOY in March. Please see Table 3. After rising about 12% YOY in 2007, overall inflation in the first quarter of 2008 for the Nairobi lower income averaged 20.5%. Inflation in Kenya's other urban centers similarly jumped from a 2007 average of about 11.5% to 20.2% in the first quarter of 2008. However, prices for the Nairobi upper income group, for whom food represents a much smaller share of income, rose from a 2007 average of about 9% to only 10.8% in the first quarter.

Q1 2008 overall inflation YOY % Changes

Item Group	Jan	Feb	Mar	Q1 average
Nairobi Lower Income	19.9%	18.3%	23.2%	20.5%
Nairobi upper Income	9.6%	10.1%	12.5%	10.8%
Rest of Urban Centers	18.2%	20.6%	22.0%	20.2%

Source: Central Bank of Kenya.

Food, Oil Prices Will Continue to Rise and Raise Others

¶5. (U) Food inflation is expected to persist through 2008 because of production shortfalls, even if the rains are good. The post-election violence drove thousands of farmers from their Rift Valley homes, and prevented most from planting the next crop. The destruction of many farm supply outlets and the expulsion of middlemen has reduced the availability of seed, fuel and fertilizer and restricted the amount of land the remaining farmers can afford to plant. Fuel costs for land preparation have risen 92% to Sh2,300 ($37) per acre. Fertilizer prices have risen 122% to over Sh4,000/50kg bag ($64), reflecting global price increases. Transportation costs have risen up to 25%, and will likely continue

to rise due to high global fuel prices.

¶6. (U) The Agriculture and Rural Development Group (ARDG) predicts agricultural production in 2008 will fall as much as 40% below average. An estimated 207,000 tons of grain in the fertile Rift Valley were destroyed during the violence. The National Cereals and Produce Board's (NCPB) maize stocks fell to 2.07 million tons by the end of March. Kenya requires about 3 million tons of grain per year, and production is expected to fall short by about 930,000 tons, requiring either increased imports, or drawing down stocks well below the preferred level.

¶7. (U) The average retail price for unleaded fuel in Nairobi rose from Sh84/liter in December to Sh95 by the end of March. In Nyanza, Western and Rift Valley provinces, where the violence and road attacks were worst, unleaded fuel prices are Sh150 to Sh200/liter ($2.42-$3.22). Kenya Shell Managing Director Patrick Obath said, "Don't expect fuel prices to come down due to the volatile crude prices." Kenyans fear they will soon see Sh100/liter prices ($6.50/gallon), which would also be reflected in higher prices for other goods and services. Tabitha Runyora, a market analyst with the Kenya Horticultural Development Program said, "Kenyans should brace for higher prices throughout this year. Charles Ocholla, the Investment Banking Manager at Suntra Investment Bank, warned "I foresee inflation rates hitting 25% by the second half of this year."

¶8. (U) Power prices rose in March, as the cost of consuming 50 kwh went up by 10.7% to KSh. 315.38 due to increases in fuel costs and foreign exchange adjustments, and more increases are likely in 2008. The Kenya Electricity Generating Company (KenGen) and the Kenya Power and Lighting Company (KPLC) have applied to the Electricity Regulatory Commission (ERC) for tariff increases in July to cover rising costs of generating, purchasing, and distributing power, and to fund investments in new power plants. The two firms proposed tariff increases of 60-171% for individual consumers, and zero to 40% for commercial and industrial consumers.

CBK Governor Sees Supply Problem, Not Monetary Issue
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¶9. (U) CBK Governor Njuguna Ndung'u told the press that the high inflation was a seasonal supply problem driven by fundamentals and exacerbated by political shocks, rather than a monetary problem. Although the underlying inflation rate crossed the CBK's 5% target ceiling in October and has continued climbing steadily, he did not offer any change in the CBK's policies of trying to mop up excess liquidity, or caution the government about increased spending on the Cabinet or recovery assistance. Ndung'u simply warned savings account depositors earning 4% annually that their savings would decline against the 5-7% underlying inflation rate. He encouraged Kenyans to consider using unit trusts to invest in the Nairobi Stock Exchange (NSE) to increase their returns and safeguard their initial investments.

Interest Rates Rise Slightly

¶10. (U) Interest rates have not yet responded much to the high inflation rates. The March 30 and April 7 T-Bill auctions were undersubscribed, as investors focused on the Safaricom IPO (ref A). The average 91-day T-bill rate rose from 6.89% on March 30 to 6.98% on April 7, while the average 182-day T-bill rate increased from 7.81% to 7.94%. Average interbank rates increased from 6.37% to 6.43% during the week ending April 3, 2008, but the repo rate remained stable at 6.45% during the week. Investors showed strong interest in longer-term government paper, overbidding the offer of Sh7 billion (about $113 million) of 15-year Government bonds by 31% despite a three basis point decline in its yield to 13.1% from November last year. Suntra Investment Bank, Manager Charles Ocholla attributed the demand to insurance companies and fund managers seeking long term assets to match their long term liabilities.

GOK Officials Finally Cut Growth Forecasts

¶11. (U) Finance Minister Amos Kimunya and CBK Governor Njuguna Ndung'u recently tempered their previous rosy claims that the economy would still grow 6% in 2008. They both publicly acknowledged the crisis would cut growth economic growth to the 4.5%

- 6% range. The GOK has not yet published tax revenue figures for February or March, making it difficult to determine what resources it is likely to have to fund reconstruction and government expenses.

Comment

¶12. (U) The increased price of staples, including food, transport, soap, and kerosene put great stress on households, many of which are facing reduced income or unemployment, forcing hard choices between eating, rent, and their childrens' education. Wages for the majority of workers have not kept pace, and it is uncertain whether the government will announce an increase in the minimum wage on May ¶1. This trend could greatly undermine the GOK's poverty reduction efforts. However, investors lined up to buy Safaricom shares or 15-year Treasury bonds have not lost confidence in Kenya's future.

¶13. (SBU) Almost half of Kenyans lived in poverty before the crisis destroyed many small businesses, drove away tourists, and put hundreds of thousands out of work. Volatile western Kenya, where support for the opposition ODM party and PM-designate Raila Odinga is greatest, is facing both a higher incidence of poverty and higher inflation. These conditions are helping to fuel civil society's opposition to the costs of proposals for an expanded coalition cabinet. While this puts pressure on the two sides to reach an agreement before the economy gets worse, it would be more difficult to reach agreement on a smaller cabinet with fewer patronage positions.

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